



BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
ROBERT G. AND PATRICIA A. PFAU )

For Appellants: Robert G. Pfau, in pro. per.

For Respondent: Crawford H. Thomas  
Chief Counsel

John D. Schell  
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Robert G. and Patricia A. Pfau against a proposed assessment of additional personal income tax in the amount of \$652.44 for the year 1965.

In June of 1964 appellants began operating a sole-proprietorship mail-order gem and lapidary supply business. A retail store was added to the business in January of 1965, and one year later the business assets were transferred to Gemex Company, appellants' newly organized and wholly owned corporation, in exchange for stock and notes of the corporation. The operation of the business continued unchanged under Gemex's ownership.

Appellants and Gemex advertised their merchandise in trade journals. In addition, appellants published and distributed a mail-order catalog in August, 1965. This catalog listed appellants' inventory, along with the prices of the various items. Gemex published and distributed similar catalogs in August of 1967 and 1968. Appellants stated that a catalog was not put out in 1966 because Gemex could not raise sufficient funds to do so.

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On their 1965 return, appellants claimed a business expense deduction in the amount of \$15,371.00, representing the entire cost of publishing the 1965 catalog. After auditing the return, respondent determined that the catalog was an asset having a useful life in excess of one year and that the cost of producing it should be capitalized and depreciated over its useful life. Accordingly, respondent allowed \$5,124.00 as a reasonable amount for depreciation and disallowed the remaining \$10,247.00 of the claimed business expense deduction. Appellants protested this determination and respondent's denial of that protest gave rise to this appeal.

Respondent's action was premised on the theory that trade catalogs are no different from other assets used in a taxpayer's trade or business. The general rule is that where the useful lives of such assets exceed one year, their costs must be capitalized and depreciated over their respective useful lives. Consequently, where the useful life of a trade catalog exceeds one year, the costs of publishing it are not deductible as ordinary and necessary business expenses but must be depreciated over the catalog's useful life. This view is followed at the federal level by both the Tax Court and the Internal Revenue Service. (Best Lock Corp., 31 T.C. 1217; Rev. Rul. 68-360, 1968-2 Cum. Bull. 197.) Both Best Lock and the revenue ruling rejected the rationale of two earlier cases, E. H. Sheldon & Co. v. Commissioner, 214 F.2d 655, and Harper & McIntire Co. v. United States, 151 F. Supp. 588, which held that the costs of producing catalogs were deductible business expenses. Even if those two cases have continuing vitality on their particular facts, however, they are distinguishable from the present appeal in that the catalogs in those cases became quickly obsolete and were frequently revised.

It follows that respondent applied the proper rule of law if the useful life of appellants' catalog exceeded one year. Respondent's determination of an asset's useful life is presumptively correct and must be shown by appellants to be erroneous. (Appeal of Continental Lodge, Cal. St. Bd. of Equal., May 10, 1967.) Appellants having failed to offer any evidence to show that the catalog had a useful life other than the two years determined by respondent, respondent's determination must be sustained.

At the protest hearing, appellants argued that if the *catalog* had a useful life exceeding one year, then it had undepreciated asset value at the time appellants

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transferred their business assets to Gemex. If that is true, said appellants, then the value of the assets transferred to Gemex exceeded the stated value of the stock and notes received from that corporation, and appellants should be allowed to claim a loss on the transaction. Such a loss is specifically precluded by Revenue and Taxation Code section 17431, which provides:

No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in Section 17463) of the corporation.. ..

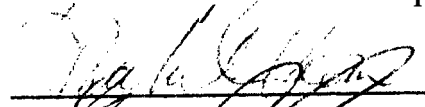
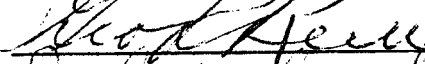


Since appellants received all of Gemex's stock pursuant to the exchange, they were in control of Gemex immediately after the exchange.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Robert G. and Patricia A. Pfau against a proposed assessment of additional personal income tax in the amount of \$652.44 for the year 1965, be and the same is hereby sustained.

Done at Sacramento, California., this 5th day of April , 1971, by the State Board of Equalization.

 , Chairman  
 , Member  
 , Member  
 , Member  
\_\_\_\_\_, Member

ATTEST:  , Secretary